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STRATEGY RESEARCH PROJECT

ASIA'S ECONOMIC CRISIS: STRATEGIC IMPLICATIONS AND CONSEQUENCES

BY

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ABSTRACT

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East Asia in 1997 became the second recent victim of financial crisis following the collapse of Mexico's currency and stock market in 1994. This crisis has since ballooned into a global crisis: Recession grips 50% of the world-including most of Asia, Eastern Europe, Africa, and Latin America, thereby reducing regional stability and security. If this crisis worsens into global depression, it will create an extremely challenging national security environment. This study examines the strategic implications of the ongoing economic and monetary crisis in Asia. It discusses potential shifts in international power relationships among the major countries with interests in Asia. It examines whether shifts in Asian economic power are causing changes in regional balances of power and national security. It assesses the effectiveness of responses by the international organizations and influential policy makers. It asks whether the "crisis" is just a "blip" (transient phenomenon) or even a healthy economic contraction to purge excesses following three decades of prosperity and high growth rates.

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ASIA'S ECONOMIC CRISIS: STRATEGIC IMPLICATIONS AND CONSEQUENCES

East Asia in 1997 became the second recent victim of financial crisis following Mexico's forced currency devaluation and stock market collapse in 1994. The Economist dubbed Mexico's economic crisis "the first financial crisis of the 21st century" due to the rapidity of the collapse and the repercussions it had for neighboring Latin American markets. What started as a warning shot in Mexico, a crisis that was expeditiously and quite possibly too naively addressed by the international community with an unprecedented international "bailout," has surfaced as the current "Asian crisis." This crisis unrelated but similar to Mexico's, has since ballooned into a global crisis, spreading to Russia in 1998 and Brazil in 1999. Recession currently grips 50% of the world, spreading to over fifty countries including most of Asia, Eastern Europe, Africa, and Latin America.² The Asian crisis precipitated rioting and demonstrations, 30-70 percent stock and currency market reductions, and accelerated deflation of assets and commodities (worldwide commodity prices are at 22year lows). Additionally, the Premiers of Thailand and Japan and the Presidents of Indonesia and South Korea fell from power.4

This study examines the strategic implications of the ongoing economic and monetary crisis in Asia. It discusses potential shifts in international power relationships among the major

countries with interests in Asia, including the US, Russia,

Japan, and China. To date China has been able to maintain a

robust 8-9 percent growth rate while they transition to a marketoriented economic system. However, Asia's crisis significantly

reduces Chinese prospects of maintaining those high growth rates.

Meanwhile, Russia's economy has collapsed and Japan is fighting a

prolonged decade-old recession.

Is there an ongoing shift in economic power that could ultimately cause a shift in the Asian regional balance of power and national security? Has the crisis response of international organizations and policy makers been appropriate and effective? Are the affected countries applying the lessons learned and implementing necessary reforms so that permanent recovery is possible? Alternatively, will affected countries revert to old habits and return to status quo as recovery progresses? Alternatively, is this just a "blip" (transient phenomenon), a healthy economic contraction to purge excesses that became commonplace during the "East Asian Miracle" of three decades of prosperity and high growth rates? This study seeks to shed light on these perplexing questions.

The financial crisis in Asia has not gone unnoticed in the United States. However, since the US economy is enjoying an unprecedented economic expansion and a sixteen-year bull market in stock and bond markets with few signs of slowing, why should the US concern itself with Asia's problems? Admiral Prueher, US

Pacific Command, offers an excellent response: "Political, economic and military aspects of security are interdependent and cannot be advanced separately. Relationships among nations can flourish only if each aspect advances together. . . The bottom line is that a continuing lack of prosperity in the region can have a negative impact on stability. This means that the aspect of military security is now more important than ever."

A RAND study for the Science and Technology Policy Institute observed "the government should recognize that the [global] economy today is its battlefield, that national security today stems from economic security. In order to prepare the US for a secure future, there is a need to strengthen the economy."6 In addition, economic globalization and interdependence has bound the world's economies together and increased US dependence on global trade. This makes the US economy increasingly dependent on the health of the global economy and vulnerable to the market collapses and financial turmoil that currently rock East Asia. Will the crisis which has now spread to fifty percent of the globe and claimed two developed industrialized nations, Japan and Russia, also spread to the US and Europe? More importantly, will it ultimately result in global recession or, worse yet, global depression, thereby creating an extremely challenging national security environment?

WHY THE ECONOMIC CRISIS OCCURRED

Three decades of robust economic and export growth coupled with abundant foreign investment tended to obscure loose, inefficient business practices in East Asia. The investment boom led to large current account deficits (trade balance plus interest payments on foreign debt) and growing unfunded public liabilities. Cozy relationships between business and political leaders resulted in inefficient channeling of capital. Most Asian financial systems were both inadequately and overly regulated, which created an illusion of security that didn't exist and thus supported exchange regimes that attracted an abundance of capital without complementary macroeconomic policies to handle speculative pressures during the inevitable economic slowdown. In his discussion on the Asian economic crisis, Mortimer Zuckerman stated "the very top-down nature of the Asian model has proved fatal. Without public scrutiny of the iron triangle of b's-businessmen, bureaucrats, and bankers-three c's inevitably followed-complacency, cronyism, and corruption."8 These fundamental problems triggered East Asia's economic crisis. Then when wary international investors panicked, the resulting reversal in capital flows magnified the crisis.

In Korea, for example, the government treated banks as tools of industrial policy and ordered them to make loans to non-creditworthy companies rather than allowing market forces to determine the most efficient use of investment capital. Experts

estimate that 10-20 percent of the total loans in East Asian banks are bad, compared to one percent in America. Japan accumulated an estimated \$5 trillion of non-performing debt that is still on the books from a buying binge around the world in the late 1970s and 1980s. South Korea officially reported 1% of all lending as non-performing in 1996. Subsequent estimates by outside observers put those misleading estimates in the 15 to 30 percent ranges.

Several factors increased the vulnerability of East Asian banks. These included rigid currency pegs (local currency fixed to US dollar rates), poor lending decisions, and insufficient financial disclosure. Banks, financial intermediaries, and corporations assumed stable exchange rates and borrowed short term in dollar-denominated form without establishing currency hedge positions to protect against the possibility of currency devaluation. When borrowers repaid their loans in local currencies that declined 60-70 percent, the shortfall forced the banks to meet their liabilities to foreign investors with dollars at a tremendous loss. Most of the governments impacted by the crisis had "pegged" their currencies to the US dollar. When the G-7 (US, Japan, UK, France, Germany, Canada, and Italy) decided to strengthen the value of the dollar, Asian governments resisted making the appropriate adjustments to their currencies. They failed to remove the peg of their currencies to the rising US dollar, thereby making their exports less competitive. 12 Leif

Rosenberger astutely identified plausible reasons why government officials adamantly maintained a rigid economic model and exhibited inflexibility in adjusting to dynamic changes in international capital flows. He stated Asian schools, which teach rote learning, "failed to develop innovative, imaginative technicians and managers with creative thinking skills for success in fast-paced, constantly changing knowledge-based industries." 13

After over a decade of easy money and abundant liquidity in Asian financial systems, bankers recklessly and complacently invested money on luxury property, grandiose construction projects, and unneeded office space. Frequently they based their investment decisions in construction projects on political favors or meddling, rather than the best economic utilization of available investment dollars. This led to a crisis in overcapacity. When bankers became convinced that rapid economic growth would continue forever, they deluded themselves into taking the outlandish financial credit risks that they incurred. Often, they did not thoroughly conduct risk analysis or ignored the results.¹⁴

One of the most prevalent inadequacies and a major cause of the financial and currency collapses in the Asian countries was the lack of transparency and disclosure in financial and corporate affairs. Banks, finance companies, corporations, government, and politicians, to varying degrees, were all

participants. Systematic obfuscation of financial and corporate accounts led to wide-ranging bankruptcies, while similar obfuscation of national accounts misled international financial institutions and investors. This lack of transparency in finance masked what was really occurring in the banking sector. Explained away as an integral part of the Asian way of doing business, large deals in Asia are often concluded with merely a handshake and loans are granted without review by watchdogs. Consequently, audit trails often do not exist. This created irresistible opportunities for abuse or intentional violations of law as in the more egregious cases, such as the Bangkok Bank of Commerce. 15 Insufficient disclosure of financial statistics in Asia delayed recognition of the breath of the problems, contributed to overreaction in public/investor perceptions (i.e. a "confidence crisis"), and led to financial market collapses as the truth became known. 16

CRISIS RESPONSE

Finance ministers and the G-7 central bank governors—along with representatives of 15 emerging/developing countries, "the new G-22,"—met in September 1998. They discussed international solutions and developed a global strategy to address the Asian economic crisis, which was rapidly spreading into a global crisis. The immediate action from the meeting was monetary intervention by European countries and US, along with interest

rates cuts. The US Federal Reserve reversed its interest rate policy, announcing three successive interest rate reductions in a two-month period. G-7 strategy was to "encourage capital reflows to the crisis countries, reduce their debt burdens and improve their competitive position by promoting a stronger yen. It would also ensure continued world growth and help prevent further stock market declines."¹⁷

Throughout this crisis, the IMF was exposed to no shortage of criticism. The IMF, as lender of last resort, has to make difficult judgments in the face of critical questions of balance when deciding when it is appropriate to bail out a failing economy and how best to structure the financial support for the affected country. US Deputy Treasury Secretary Lawrence Summers offers this perspective: "It is vital to remember that the distress and difficult outcomes being seen in Asia are not a consequence of IMF policies or IMF finance. These are, rather, the attempts to palliate the true cause of the distress: the withdrawal of private capital and declines in domestic confidence that led to that withdrawal. Put simply, we must not confuse the doctor with the disease." 18

IMF critics claim, however, that the austerity medicine prescribed by the IMF for countries applying for rescue loans was ill-advised in the early stages of the crisis. The IMF insisted on immediate increases in interest rates, currency float and devaluation, drastic fiscal cuts, and increased taxes. These

longer-term recovery reform measures dramatically shrunk money supply at a time when moderate short-term stabilization measures were more appropriate. IMF loans served more to bail out international banks and investors and ended up strapping the economy and people of the affected countries with tremendous levels of debt. This led to skyrocketing unemployment, soaring taxes and interest rates, and widespread local bank closures. The primary short-term focus of the IMF should be to calm panicked investors and restore confidence. The best long-term medicine is for these countries to establish free enterprise, bring in foreign competition, and allow bankrupt businesses to fail or to consolidate. 19

Much of the debate centers around concerns that IMF bailouts encourage "moral hazard," thereby encouraging investors and policy makers to incur additional risk due to the perception that they will be bailed out if things go wrong. Some argue that the Mexican IMF bailout set such a precedent. The IMF must weigh the cost and benefits to the global community of intervening in the natural process of economic failures to purge excesses and force policy reforms. The cost of not intervening can be excessive panic and over-reaction by investors. This choice of inaction by the international community can potentially result in a larger number of debt defaults, deeper asset and currency devaluation, trade dislocations, and greater likelihood of the crisis spreading to nearby countries.

CRISIS IMPACT BY COUNTRY

Despite being the world's second largest economy, JAPAN: Japan is suffering through a deep, relentless recession (on the verge of depression). It faces banking system problems considerably larger, proportionate to their economy, than the US savings and loan crisis in the early 1980's.22 The trigger for Japan's current recession, which began in 1991, was the collapse of real estate and stock market prices after a manic asset "bubble" market developed in the 1980s. The ongoing decline in stock and real estate prices continues to jeopardize the financial health of Japanese banks stuck with the loans secured by these assets. The unwinding of asset prices resulted in cumulative capital losses of "\$7 trillion or two years' worth of Japan's Gross Domestic Product (GDP)."23 George Brockway best describes the extent of the Japanese 1980s real estate buying binge: "In Japan, whose area is slightly less than that of Montana, the value of real estate ballooned to double that of the entire United States. When the balloon burst in the early 1990s, Japan went into a recession it has yet to shake."24

The plight of Japan's economy is significant for several reasons. Japan's economy is five times the size of China's. Consequently, it has the greatest impact on and offers the most opportunity for Asia's recovery. Additionally, Japan is the US's primary security partner in the region. Japanese stability is

important to regional security, which is a prerequisite to regional economic recovery and growth.

Many observers believe the key to Asia's recovery is Japan; however, close analysis reveals that before Japan can help Asia, it desperately needs deregulation and massive restructuring of its own obsolete financial system and cartel economic model. Japan has not modernized its financial bureaucracy, economic system, and most banking regulations since W.W.II. Their system is still "fundamentally a continuation of their 1940's wartime system of total mobilization of economic resources. . . True, the bank's goal. . .changed from the execution of war to the achievement of economic growth in the postwar period, but the system, geared as it was to all-out war, remained intact."25 There are numerous reasons this system is failing, including artificially low interest rates that do not encourage domestic investment and a cartel system that inefficiently channel savings into selected industries. 26 Until Japan makes fundamental changes, their financial system will not be able to sufficiently respond to and meet the challenges of today's dynamic global economic environment. Consequently, Japan's recent implementation of numerous stimulus spending packages, including public works projects and tax cuts, has generated little response or improvement in their economy. Depressed by the prospects and potential impacts of economic restructuring, Japanese consumers refuse to spend.27

Japan has held its short-term interest rates below one percent since 1996 in its attempts to end its recession. Paul Krugman claims that Japan is in a classic "liquidity trap" where monetary policy does not stimulate business and consumers refuse to invest liquid cash. He claims the US and British economies approached a liquidity trap during the 1930s Great Depression. However, before Japan's current predicament, academicians generally concurred that the modern financial system insured against the recurrence of liquidity traps. Now that Japan's economy has deteriorated to full-blown recession and potential depression, Japan must acknowledge that to turn their failing economy around, they must implement painful fundamental and structural changes. However, Japan refuses to accept this reality. 29

Japan's unwillingness to absorb local imports from the region has hindered East Asia's recovery and severely tarnished Japan's regional leadership. Additionally, as Japan tries to export its way out of this crisis, its trade surplus with the US has risen dramatically. This has caused outcries in the US for barriers, evident in contentious statements by US policy officials. Trade barriers will undoubtedly raise anti-American sentiment in Japan, a national security concern since Japan is America's primary security partner in the region, serving as a balance of the combined power of China, North Korea, and a resurgent Russia.³⁰

CHINA: China, the world's most populous country and seventh largest economy, has escaped the economic crisis relatively unharmed. It is the most rapidly expanding economy in the region; it continues to maintain, with increasing difficulty, an explosive eight percent rate of growth. In sharp contrast to Japan, China has openly admitted its economic failings. It is aggressively overhauling its antiquated financial system, pursuing initiatives such as membership in the World Trade Organization (WTO), and implementing economic reforms and structural changes required to compete in today's global economy. 31

Despite claims to the contrary by Chinese officials, it is unlikely that China can both maintain its stipulated eight percent growth rate goal and implement its ambitious economic reforms. The combined impacts of economic reforms and Asia's financial crisis will force the economy of China to slow. Charles Wolf has identified five reasons why growth rates in China will likely slow in the next decade. The inflow of capital, particularly foreign direct investment, will probably diminish. Capital-to-output ratios in China for new investments will increase due to heavy public investment in infrastructure projects. Operating and production costs of state-owned enterprises will rise as a result of reforms and privatization of the state sector. China may redistribute income from relatively high productivity coastal regions to low productivity central and

western provinces. Finally, resource allocations to China's military forces and technology must increase to fund Deng Xiaoping's "Fourth Modernization."32

The economic crisis has forced China to slow the pace of its ambitious reforms. Aware that they have many of the same problems as the rest of Asia, China is desperately trying to avoid the "Asian Contagion." By refusing to succumb to economic pressures to devalue its currency during Asia's current crisis, China is trying to avoid becoming the cause of further deterioration in neighboring Asian economies. This has improved perceptions of China among world powers and earned it the regional reputation as the crisis hero. Perceptions of China's positive role are in sharp contrast to those of Japan, which has done little to alleviate East Asia's plight. 33

Even so, China has serious financial deficiencies that its leadership must correct. These include excessive industrial capacity, inefficient state-owned enterprises, a bank-dominated financial system, weak central bank regulations, corruption, and poor supervision of commercial banks. Similar to Japan in the 1980s, China has excess lending problems that are showing up as "asset bubble" formations, especially in real estate. ³⁴ Overhaul of China's banks, the most fragile banks in the region in terms of capital adequacy, profitability, and bad-loan ratio, will be a massive undertaking. The percentage of non-performing loans has

steadily increased to 25 percent, substantially higher than precrisis South Korea or Thailand.³⁵

With its deep structural economic problems, vulnerability to a collapse in "asset bubbles," and enormous 1.2 billion population, failure of China's reforms could lead to political instability and social unrest. The economic and financial health of China, as well as sound Chinese policies, is critical to regional stability in East Asia. Devaluation of their currency could trigger a chain reaction that would deepen East Asian recession and asset deflation. The key to stability, and ultimately to US national security concerns in the region, is the ability of China to execute the major reform program it has embarked on. 36 Success would enable China to remain competitive in Asia, raise production, and restore access to international capital markets and foreign direct investment. Nicholas Lardy, Senior Fellow at the Brookings Institution, believes the best US strategy is one that supports China's "energetic domestic reform program and tempering demands for immediate liberalization of China's banking market."37

INDONESIA: Indonesia has benefited from dramatic economic growth in Asia since 1970. The proportion of the population living below the official poverty line decreased from 60 percent to 11 percent; infant mortality and average Indonesian quality of life significantly improved; and life expectancy rose from 46 to

63 years. Universal primary education began in 1995.38 However, Indonesia's economy was the most severely affected by the current crisis: It contracted by 20 percent in 1998. It has all the ingredients required for massive social unrest. It is the world's fourth most populous nation, has rampant inflation, widespread government corruption, and authoritarian rule. These factors, combined with the pressures of the Asian economic crisis, led to widespread student protests and riots. 39 A \$40 billion IMF bailout package was structured and executed to restore confidence and encourage sorely needed economic reforms. Despite the bailout, Indonesia's recovery has been the slowest of all the Asian countries. 40 Max Corden concluded "Indonesian recovery depends on the restoration of private sector demandwhich in turn depends on the restoration of confidence-and additionally it depends on the efficient cleaning up of the banking system and of the corporate debt situation-which will, among other things, overcome the trade credit problem—and on the restoration of public order and confidence in government."41

THE OTHER ASIAN TIGERS (Thailand, Malaysia, Singapore, South Korea, and Taiwan): Seemingly invincible economic powerhouses prior to the economic crisis, Asian "tigers" gained significant economic power during the last two decades. They grew more rapidly and consistently than any other group of economies in the world, averaging eight percent growth since mid-1990.42 In

general, these countries are rich in resources, have ample inexpensive labor, and a literate, well-educated population.

Despite these advantages, many of the factors discussed earlier that made Asia's economies vulnerable to economic crisis were common to all these countries. When economies began to slump worldwide during the mid-1990 timeframe, the subsequent slowdown in export growth triggered Asia's economic crisis. Most of these "Asian miracles" are still struggling today to recover from this crisis.

Thailand signaled the beginning of Asia's economic crisis in July 1997 when it floated its currency due to a large deficit accumulating in its current account for balance of payments. The deficit was eight percent of Thailand's GDP; it was increasingly funded by potentially volatile short-term capital inflows. Large capital inflows also fed a real estate bubble that burst in 1997, leaving many financial institutions insolvent with substantial amounts of non-performing loans. Thailand subsequently negotiated a \$17.2 billion emergency rescue package from the

By November 1997, the crisis spread to South Korea, triggered by the bankruptcy of several of South Korea's largest conglomerates (Chaebols), including Hanbo Steel, Ssangyong Motors, Kia, and several smaller Chaebols. Their combined debt was more than \$60 billion. These bankruptcies made the depth and breath of South Korea's economic inefficiencies more obvious to

investors and led to massive capital flight. Eventually South Korean officials reluctantly negotiated for a \$57 billion IMF bailout. 46

On the other hand, Taiwan has shown remarkable resilience throughout Asia's economic crisis. Therefore, Taiwan provides a good case study for other countries in the region on steps they should take for recovery. Taiwan has been implementing broadbased economic reform since the early 1990s, when it suffered a collapse following a bubble market in 1990. Reforms include mandated transparency, liberalized financial markets, removal of extensive trade barriers and tariffs, privatization, introduction of foreign competition, and implementation of qualification requirements—as well as application for WTO membership.⁴⁷

ROLE OF GLOBALIZATION, INTERDEPENDENCE, & TRADE POLICY

Acceleration trends of globalization, economic interdependence, and financial market liberalization have been developing over the past two decades. They bind world economies, making each country's economy more vulnerable and dependent on movements within their region and the global economy. World leaders must assess the ramifications of current international policy of unregulated money flows and emerging capital flow challenges. To avoid crises in the future similar to the one in Asia, these leaders should establish appropriate capital adequacy

standards, implement stronger global public policy, and draft a modernized international financial framework. 48

An astonishing factor of this crisis has been the unprecedented speed with which investors moved capital out of these economies. This capital flight exaggerated the effects and depth of the subsequent collapses and accelerated the spread of the crisis through the Asian region and eventually to other regions of the world. The rapid transfer of capital, a phenomenon referred to as the "Asian contagion," was facilitated through vast improvements in electronic technology. Asia's economic crisis brought to the world's attention the significance of recent technological advances in information systems that have significantly increased the speed of global financial transactions and capital flows. Additionally, the crisis highlighted the tremendous liquidity increases in financial markets due to deregulation, liberalization of financial markets, and the development of derivatives and other sophisticated financial instruments.49

The "East Asia Miracle" was based on a handful of small countries maintaining 20% export growth rates. However, this dramatic growth became unsustainable when large economies, including Indonesia and China, also tried to base their economies on the 20 percent export growth model. The economic laws of supply and demand prevailed when East Asia developed the "classic crisis of overcapacity—too many factories producing too much for

too few consumers."⁵⁰ Now that the bubble has popped, the latest component of this crisis is growing trade deficits with Asian countries. Trade deficits are rising as affected nations try to aggressively export their way out of the crisis, putting a tremendous burden on North American and European Union (EU) economies expected to absorb Asia's surging exports.

As US trade deficits soar to significant new highs with countries experiencing financial crisis—especially China and Japan, with their enormous economies—tension and trade disputes are likewise rising. The main concern is that the widening trade deficits are siphoning growth from North American and West European economies, thereby suppressing their GDP growth. Michael Mussa, Chief Economist of the IMF, estimates that "the crises in Asia will cut roughly half a trillion dollars from collective Gross Domestic Product (GDP)."51 This imbalance can negatively affect global stability and national security.

The importance of trade policy is increasing as the US and Asia, as well as the rest of the world, becomes interdependent due to globalization and the dramatic growth of trade. US trade with Asia has grown to \$500 billion per year, 37 percent of America's world trade. The benefits of increasing levels of trade with Asia makes it prudent for the US to establish policies that are favorable to Asia's recovery, such as temporarily accepting trade deficits.

Asia's economic crisis, exacerbated by the lack of market discipline, clearly demonstrates the importance of free trade and open markets. Trade restrictions, import monopolies, and excessive regulations protected the favored sectors and special interests and eventually eroded Asian market discipline and efficiency.⁵³

President Clinton began shifting America's national security strategy, especially economic strategy, towards a multilateralist framework. This framework assumes nations share values and goals; consequently, they will cooperate, through globalization and interdependence, to pursue common goals.54 A logical starting point for examining current US trade policy begins with US grand strategy, the strategy of preponderance. The essence of this strategy, according to Christopher Layne, is a "US-led world order based on preeminent US political, military, and economic power, and on American values." He then asserts that "interdependence is the paramount interest the strategy promotes; instability is the threat to interdependence; and extended deterrence is the means by which the strategy deals with this threat."55 Why should our national strategy promote economic interdependence as a national interest? Policy-makers believe interdependence serves as both a cause and consequence of peace and stability. Increasing world prosperity with an open international trading system will: 1) Decrease the risk of war because states are less likely to risk their trade and prosperity

to war. 2) Prevent emergence of economic nationalism and rival trading blocs, which led to instability in 1930s. 3) Provide all states nondiscriminatory access to markets and resources. 56

Current US strategy to address the Asian and global economic crisis, including trade policy aspects of that strategy, is articulated in A National Security Strategy for a New Century. President Clinton stated in his preface to the National Security Strategy (NSS) that the "United States has profound interests at stake in the health of the global economy. Our future prosperity depends upon a stable international financial system and robust global growth."57 The NSS preface clearly reflects the priority the Clinton Administration places on the US taking an assertive role in resolving Asia's crisis: "We are taking a number of steps to help contain the current financial turmoil in Asia and other parts of the world. We are working with other industrialized nations, the International Monetary Fund and the World Bank to spur growth, stop the financial crisis from spreading, and help the victims of financial turmoil." 58 The Administration recognizes the US must remain a leader in shaping the global economy. Accordingly, it has designed its trade policy to sustain prosperity by creating an ever-expanding global economy.

Pursuit of free market reforms, promotion of open investment, negotiation of a series of bilateral and multilateral trade agreements, and creation of export opportunities across Asia, as well as Europe, Latin America, and Africa are enabling the US to

achieve these goals.⁵⁹ To improve the global trading system and ensure stability, the US is aggressively enforcing trade agreements and laws. It has established a strategic enforcement plan that includes challenging existing trade barriers as well preventing adoption of new ones. This US is committed to resolving disputes regarding global rules through the WTO dispute settlement procedures.⁶⁰

The same forces of globalization that had an important role in the creation of the "East Asia Miracle" will also ensure its future prosperity. Developing economies, especially in Asia, are playing an increasing role in the production of goods. This creates a win-win situation for both mature and developing economies. Innovators selling into Asia's expanded markets receive more incentive to exercise their entrepreneurial ingenuity. Developing economies in Asia benefit from the fruits of those innovations as well as their increased participation in the production of those innovations through multinational enterprises. The combination of rapid advancements in technology, globalization, and trade liberalization has become an economic force multiplier, sparking unprecedented innovation and productivity.

Policymakers shaping US policy and national security strategy are leveraging the benefits of the globalization process and explosive growth in technology. The US continues to provide world leadership on trade policy, globalizing its economy faster

than any other major industrial power. It now has fewer non-tariff trade barriers and is the most open economy among major industrial nations. Asian governments must pursue similar policy strategies. There are signs of progress: Undeveloped China, for example, is opening its economy faster than the US.62

STRATEGIC CONSEQUENCES/IMPLICATIONS TO NATIONAL SECURITY

The East Asian economic crisis can significantly affect relations among the major powers with interests in the region: US, Japan, China, and Russia. Tensions have risen as US policymakers blame Japan for contributing to Asia's crisis and offer unending advice to fix their economy. Japan is resentful of perceived US "heavy-handed" pressure in trade negotiations. The deceleration of Japan's economy and the rapid growth of China also affect regional prestige and roles. The emerging power of the Chinese economy concerns Japan. This, in turn, has strengthened US-Japan bilateral agreements.

To date China has been able to maintain an eight percent growth rate; however, as noted earlier, that may change dramatically during the next decade as China implements critically needed reforms and is hampered by the Asian crisis. Despite slower growth, experts predict that early in the 21st century the volume of China's GNP will surpass Japan's. Then China will eventually overtake the US economy. Sometime in the 21st century, the GNP volume of China will be larger than that of

the US and Japan combined. However, due to the massive population of China and anticipated population growth, it will still significantly lag behind the US and Japan in GNP per capita as well as income per capita. 64

China has become a leading trading nation of the world. Its foreign trade with the US grew from \$20.6 billion in 1978 to \$195.8 billion in 1993; likewise, China has become Japan's second largest trade partner. Japan has become China's largest trade partner with trade exceeding US\$40 billion in 1997.65 This will undoubtedly increase China's role in Asian power relations.

Given the significant potential of China, it is imperative that the US aggressively pursues its current policy of engagement with China. A stronger, larger Chinese economy will not guarantee eventual democracy in China. However, WTO membership qualification, membership in the World Bank, IMF, and other international organizations, and participation in the current rule-based global trade system—all of which China desires to further develop its economy—will naturally move China towards democracy. Strong US and global leadership should ensure that the continued opening of the Chinese economy spawns greater democracy. ⁶⁶ As China becomes more democratic, the more likely it will evolve into and remain a peaceful nation—which is a favorable strategic outcome.

Murray Weidenbaum and Harvey Sicherman expect Chinese growth to drop well below the anticipated eight percent growth rate.

They claim "this creates new uncertainties about China's modernization, political evolution, and foreign policy. As a consequence, both Beijing and Washington will face new difficulties and narrower margins of error." However, Frank Umbach believes a slow growth environment offers a "`window of strategic opportunity' that hopefully will be used in establishing new confidence-building measures." He also predicts that "the coming years might witness enhanced military transparency and co-operation as a surprising yet welcome side-effect of the ongoing economic difficulties."

The implications of East Asia's economic crisis on arms sales present a double-edge sword. The crisis has significantly reduced military procurement budgets and slowed the arms race/build-up in the "Asia-Pacific region, the world's second strongest arms export market in the post-Cold War era (after the Middle East)." The slower regional arms build-up improves regional stability, provided the relative rates of military modernization remain proportional throughout the region.

However, this may not be the case. China's modernization program may not be slow enough to maintain relative military parity among the nations in the region. Actual evidence of uneven military modernization because of the economic crisis is appearing already. Singapore, which was affected less by the crisis than its neighbors Malaysia, Indonesia and Thailand, has increased its 1998 defense budget by 5% and forged ahead with arms

procurements. This kind of military capitalization on economic instability leads to mistrust and unsettled regional security. 70

The other side of that double-edge sword is reduced modernization and multinational-training exercises with other militaries in the region. Southeast Asian countries have not conducted joint exercises together to identify and resolve interoperability problems. As the economic crisis drives these countries towards diversified collections of combat equipment acquisitions from US, EU, and Russian suppliers, compatibility and interoperability challenges will be significantly magnified. 71

Regional security partners, such as South Korea and Japan, will find it harder to pay the US for host-nation support. The shrinking arms market in East Asia will increase competition between US, EU, and Russian arms producers and encourage price "dumping" and weapons technology transfer to the region. Russia, which is using arms exports to relieve its own economic crisis, has implemented a much more liberal arms export strategy. Cashstrapped countries in East Asia are now more likely to resort to low-priced Russian produced weapons. Additionally, reduced arms sales to the region negatively affect the US defense industry and worsen existing trade deficits. A reduced US defense manufacturing base and increases in production costs from losses in economies of scale will ultimately raise the cost of US military modernization.⁷²

While many have expressed concerns that these and other impacts of the economic crisis negatively affect national security, Brookings Institute Senior Fellow, Mike Mochizuki, has observed an increase in "concerted bilateralism" in the region. Thus, he offers a different perspective:

The security risks from the regional economic turmoil may in fact be impelling the major powers to push ahead on improving bilateral relations. Washington and Beijing appear eager to keep their relationship on an upward track. The recent decision to resume the crossstrait dialogue between China and Taiwan will further ease US-Chinese tensions. Not to be left behind diplomatically, Japan and Russia have agreed to develop jointly the disputed "northern territories" and sign a peace treaty by year 2000. Japan and China have also revived their ties after a period of tension over China's nuclear tests and Japan's decision to strengthen its defense partnership with the United States."

The economic crisis in Asia and its subsequent deceleration in growth have reduced the worldwide demand for commodities. This fall in demand negatively impacted trade balances and devalued the currencies of countries heavy in commodity production and export. One such country is Russia. The devaluation of the Russian ruble destroyed their banking system, resulted in a failed IMF bailout, and triggered a global credit tightening on emerging and developing-market debt. The IMF's credibility was tarnished and the stability of the world's financial system was called into question when a bailout package could not be designed to arrest Russia's financial collapse. The national security implication of a bankrupt Russia, with its mammoth stockpile of nuclear weapons and materials, is obvious.

David Jablonsky eloquently makes the case that world security and economies are cyclical; he notes that the time cycle for global wars is 100 to 150 years. He also cautions that global leaders must implement prudent and appropriate caution because economic interdependence, which during the shorter term is healthy, can increase the likelihood of war over the long-term cycle. As long as nations believe a secure international security system is in place, trade will flourish. However, when security declines, trade will diminish as nations begin to reduce their perceived vulnerabilities and dependence on other nations to put more emphasis on political and economic self-protection. To

Today, the US, as sole superpower, is assuming leadership in orchestrating the creation of the interdependent global rule-based trading system. The primary instrument has been bilateral agreements. Now the focus is shifting to multilateral agreements for further expansion of the world's trading system through regional trade arrangements. These efforts will ensure the continued growth and health of the global economy, which Asia desperately needs to recover from its current economic crisis.

Lack of prosperity has reduced regional stability and security in Asia. Have these unsettling circumstances increased US vulnerability? Although a global depression is unlikely, the ingredients that could trigger one are in place. Consider this plausible "wildcard" scenario: Global depression would create an extremely challenging national security environment. Speculative

bubbles in asset markets and high debt, concurrent with a deflationary environment, contributed to Asia's economic crisis. Speculative bubbles have historically triggered stock and bond market collapses, including recent economic collapses in Taiwan, Japan, and Thailand in Asia. US asset markets are currently experiencing an unprecedented speculative bubble. Since the US also has excessive debt in the same global deflationary environment, it is also vulnerable to an economic crisis similar to the Asian crisis. The US has become a debtor nation with over \$5.3 trillion in national debt; its growing trade deficit adds to the national debt. 78 US citizens have unprecedented levels of personal debt. Total Consumer Credit Outstanding, which was steady at \$780 billion 1990-93, almost doubled to \$1323 billion during the past six years. 79 For the first time since the 1930s, a deflationary business cycle vice inflationary cycle exists. Additionally, Asia's economic crisis heightens the possibility that current global deflation, as reflected in commodity prices at 22-year lows, could spread to other sectors of the economy, including manufacturing and industrial production.80

The World Bank staff stated in their 1998/99 Global Economic Prospects report that: "There is still substantial risk that the world economy will plunge into recession in 1999 rather than experiencing the sluggish growth described in the baseline outlook. This risk derives from a set of interconnected and mutually reinforcing contingencies: a worsening recession in

Japan; a loss of confidence in international capital markets, leading to an extended shutdown in private capital flows to developing countries (especially Latin America); and an equity market correction of 20-30 percent that depresses growth in the United States and Europe." 81 We have yet to ascertain whether East Asia's current recovery is permanent or just a counter-trend bounce that forestalls eventual failure. If this economic bounce in Asia fails while Latin America and Russia are still experiencing recession, this crisis could trigger global price collapses in North America and Europe similar to those that occurred during the Great Depression. Market collapses in the large developed countries could cause rapid, dramatic shifts in consumer confidence and lead almost overnight to a concurrent over-production/under-consumption scenario that existed during the Great Depression and today plagues Japan. 82 Only time will tell. If Asia's recovery does fail and its economies fall to new lows, the important test for world leadership and the global financial architecture may be their ability to control a deflationary triggered global market collapse.

RECOMMENDATIONS

The US should continue to press for East Asia's vigilant pursuit of reforms. The US should encourage East Asian countries to open their economies to competition and capital flows. Poor financial supervision and weak management, inadequate control of

risk, and the inefficient employment of investment resources—all problems that persist in Asia, —are the hallmarks of protective financial systems which shelter economies from outside competition. Exposure of Asian economies to non-domestic competition will encourage sorely needed reforms. Therefore, any long-term solution to Asia's crisis must include bringing foreign banks and financial firms into these countries to compete with Asia's local companies. These governments must give their people and firms the freedom to buy internationally traded financial services and allow the free flow of lending and borrowing of capital across borders. Exposure of investment investment in the second services and allow the free flow of lending and borrowing of capital across borders.

Due to interdependence, US markets are vulnerable to the effects of the world's economic problems, including the recent currency crises and market failures in Asia, as well as in Latin America and Russia. Consequently, US trade deficits with these countries are soaring. US officials must strongly encourage America's trading partners to engage in the economic and market reforms demanded by the IMF for shoring up their banks. So Consequently, the US needs strategies to address trade deficits which periodically erupt as a political flash point need to be developed and implemented. A good starting point is to improve the accuracy of the balance of trade statistics collected. Robert Reich describes these numbers as notoriously imprecise, subject to wide swings and seemingly inexplicable corrections. So Dwight Murphy estimates US exports are under-reported by at least

10 percent because reporting does not include all sales abroad by US corporations through their subsidiaries and affiliates. He claims that more accurate accounting could swing negative trade deficits all the way to an equally positive level.⁸⁸

The US should continue to press China to join the WTO and, most importantly, insist on its strict compliance with membership qualification criteria. China's acceptance of global trading regimes/norms increases the probability that China becomes a more democratic government and peaceful nation.

Strategically, Asia's economic crisis should serve as a "wake-up call" for the international community. An important lesson of this crisis is that the architecture of the world's financial system needs an overhaul to address the post-W.W.II/Cold War challenges of globalization, interdependence, free trade, and open markets. Both domestic liberalization and deregulation at the national level-along with sound public policy at the global level-are important. 89 As recommended by The World Bank, World leaders must improve this system in order to address "excessive volatility (euphoria and panics)" and reduce the world's vulnerability to regional and global recession. 90 Before this crisis, academia and market watchers around the world believed that the zero growth "liquidity trap" that exists today in Japan would never happen again in a developed country after the Great Depression. To most observers' surprise, it has! Stricken countries bear the responsibility to restore their own

economies. However, world leaders and policy-makers must use the lessons from this crisis to make the necessary changes to the world's financial architecture to prevent reoccurrence and spread of the crisis to the remainder of the globe.

CONCLUSION

There are historic links between economic deterioration, trade wars and military conflict. Avoiding such an outcome in Asia will be crucial to the continuing security of the region in the twenty-first century. 91

Overall, Asia's economic and monetary crisis is most likely a long overdue cyclical event—a healthy, but painful, economic contraction to purge built—up excesses and repair the structural financial deficiencies that exist in the Asian economies. It is a blip on a long economic journey in the overall growth of this dynamic region of the world. Complacency in Asia became prevalent after decades of "Asian Miracle" economic success. Asia's leaders and finance ministers are now much more aware of the importance of establishing sound economic policy. IMF reforms will help ensure recovery and the continued prosperity and stability in this important region.

During this crisis China has exhibited remarkable resilience, but most importantly it demonstrated the political will and ability (it certainly has the resources) to eventually become the dominant economic, military, and political leader in the East Asian region. In this dynamic environment, strong US leadership

is critical in shaping the evolution of China's emergence, such as encouraging Chinese membership in all important world organizations such as the WTO, as well as in economic summits (G-7). China has a large economic base and the potential for self-sufficiency. However, it is far more likely to join the rest of the world to seek the irresistible rewards of comprehensive globalization. US engagement in the transformation of China increases the likelihood of the emergence of a somewhat democratic China that functions as a partner of the US, rather than as an adversary.

The US has always had to resist isolationist tendencies.

Many critics point to the inherent risks of dependency on the global economy and to the inequities of globalization and open markets. These concerns were especially apparent in the late summer/fall of 1998 when the world's leaders narrowly averted a global market meltdown. Nonetheless, America's strong world leadership and aggressive efforts to globalize and establish a worldwide interdependent system for international trade strengthens the global system, improving the prognosis and establishing the required economic environment for East Asia's recovery. The internationalist strategy is a winner for the US as well: One-third of the US increase in gross domestic product is from exports.⁹³

In Asia, leaders are gradually removing the protectionist regimes that contributed to their economic crisis. In today's

relatively safe security environment, nations feel sufficiently secure in committing to and building a complex array of bilateral and multilateral trade agreements. Consequently, world leaders have made good progress toward forming an effective, rule-based interdependent global trading system. At least for the near future, nations' pursuit of profits should outweigh their natural inclination towards protectionism.

Asian governments must fundamentally reform their banking and corporate governance systems. The challenges for national leaders, however, will be managing the inevitable social disruptions and sustaining political support during this painful process. An encouraging, positive aspect of the crisis is that it is forcing Asia's governments to open their financial markets and to address the pressing need to rebuild their banking systems. The efficiencies that global competition and finance are bringing to these economies will ultimately make Asia's economy stronger than ever and, consequently, more politically and socially secure. Equally encouraging to regional stability and security is the trend towards increased military transparency and enhanced cooperation, evidence of "concerted bilateralism," and the slowdown in military modernization and arms sales in the region due to the economic crisis.

It appears that the worse of the financial crisis is behind East Asia. The region is on the road to recovery. This assessment is contingent on the developed industrialized nations

of the world not slipping into recession. If North American and West European countries fall into recession, then all bets are off. Although unlikely, such an occurrence would make it difficult for these countries, including the US, to keep absorbing East Asia's export imbalances to continue floating Asia's recovery.

As with most everything in life, Asia's financial crisis has its positive aspect. Tim Healy states it well:

"Deflation puts a premium on competence," says Xie [Andy Xie is an economist for Morgan Stanley Dean Witter in Hong Kong]. "It will destroy mediocrity." While the key to success used to be whom you know, in the Asia of falling prices, it is what you do and how well you do it. The rise of competitive enterprises in markets where price and quality are king—that transformation of Asian businesses may yet become deflation's silver lining.

Word count 8,000.

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